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In Revolving Eurozone Crisis, All Eyes Are Now on Spain

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Fears about Europe's debt debacle have reemerged in recent weeks, putting economically-challenged Spain squarely in the crosshairs of the unforgiving bond markets.

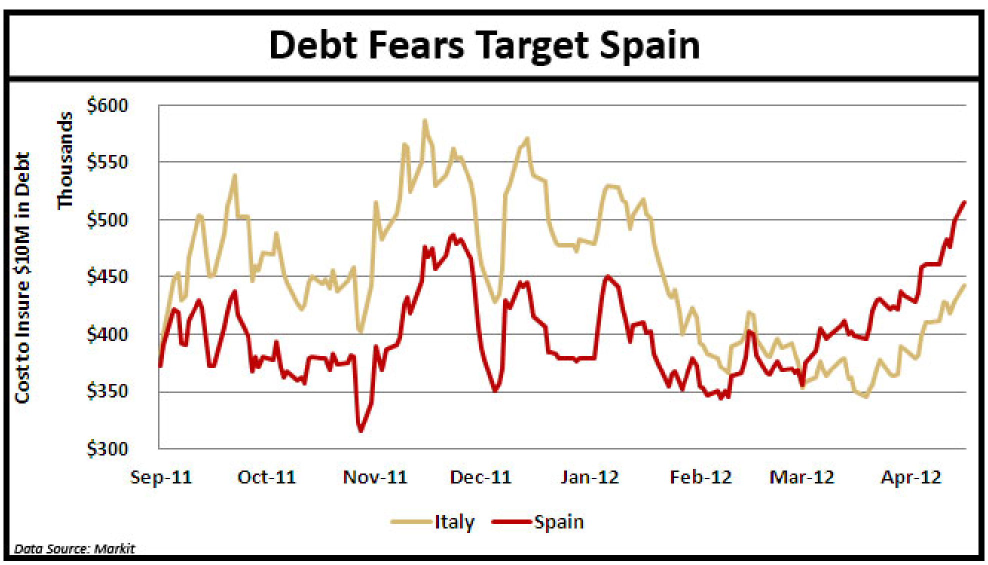
Triggered by new jitters about Spain's budget and its ability to grow amid painful austerity measures, the new pressure on Madrid is causing the country's borrowing costs to soar to alarming levels and creating turbulence for equity markets around the world.

It's also fueling a sense of déjà vu for market participants who have already seen this storyline (crisis, bailout and repeat) play out in Greece, Ireland and Portugal.

"Spain has replaced Greece and Portugal as the chief source of market anxiety," currency analysts at Brown Brothers Harriman wrote in a note this week.

The starkest evidence of the pressure mounting on Spain comes via the bond markets, which on Monday drove the yield on Spanish 10-year government bonds to four-month highs north of 6%. Yields, which move in the opposite direction of prices, had been safely under the 5% level earlier this year.

Likewise, the value of insurance contracts linked to Spanish bonds is soaring again. Since bottoming out at $344,000 in early February, the cost to insure $10 million of Spanish debt has surged 49.7% to an all-time record of $515,000 on Monday. By comparison, the cost to insure Italian debt stood at $442,000, while France was at just $189,000.



Budgetary Concerns Mount

While the script with Spain has similarities with its bailed-out peers, the stakes are decidedly higher given its much larger size (Spain's 2011 GDP was estimated at $1.536 trillion, compared with Greece's $305 billion).

"Spain is the single most important country in the Eurozone crisis. Indeed, it has always been," Cam Harvey, a finance professor at Duke, wrote in an email.

Otis Casey, director of credit research at Markit, echoed those concerns. "It's one thing if Greece is credit challenged," he said. With Spain, "people are concerned that the euro itself is a stake."

While Greece received all of the attention earlier in the crisis, Spain has come into focus as investors worry its debt burden is too steep and economy too weak to escape its current trouble.

Those jitters resumed last month when the government set its budget deficit target at 5.8% of GDP instead of the 4.4% goal agreed to with the EU.

The higher target, later lowered to 5.3%, was due largely to Spain's weak economy, which features an EU-high unemployment rate of almost 24%. This week the International Monetary Fund forecasted Spain's fiscal deficit will be at 6%.

ECB Stuck on the Sidelines

Unlike countries with their own central bank, Spain and other eurozone nations don't have the option of printing more euros to ease their debt burden and stimulate growth (and perhaps create an inflationary spike).

"It seems to be like walking up a downward escalator. They're hamstrung in more ways than the U.K. and U.S. are and they are being charged accordingly" by the bond markets, said Jan Randolph, director of sovereign risk at IHS Global Insight. "They haven't got the fairy godmother of the central bank like the Anglo-Saxons do."

At the same time, the financial markets are reflecting the realization that the European Central Bank doesn't appear willing to initiate a third long-term refinancing operation, or LTRO.

Flooding European banks with more than one trillion euros, the first two LTROs were credited with easing the crisis by ending the liquidity strains and lowering the chances of a bank collapse. They also freed banks up to buy more eurozone debt.

However, the rescue measures did nothing to solve the underlying structural imbalance of a lack of growth coupled with mounting debt levels.

"The LTRO was a life saver that was thrown to drowning economies. It kept them afloat, but didn't get them out of the water," said Jack Goldstone, a senior fellow at George Mason University. "In a sense, we're back to where we were a year ago."

Even though Spain sold a larger-than-expected $4.18 billion of bonds on Tuesday, it was forced to nearly double its yields to entice investors. The average yield on 12-month debt surged to 2.623% from 1.418% on March 20.

In a sign of how Spain has claimed the spotlight, relief over the bond sale sent global markets rallying, helping to push the S&P 500 more than 1.5% higher on Tuesday.

Greek Like Me?

While the comparisons with Greece are obvious, there are a number of important differences in the case of Spain.

For example, unlike in Greece, Spain's debt mess is primarily (for now) a private sector issue as its public debt levels are lower than many of its peers.

Also, Spain's troubles have become a regional government headache. The country's various regions are bleeding euros while reports swirl about whether these government's budgets are as accurate and transparent as originally thought.

Further, while Greece's economy collapsed, with its GDP plunging 6.9% last year, IHS forecasts Spain's will "only" contract 1.6% this year.

It's also not clear that the 7% yield threshold thought to indicate an unsustainable level of borrowing costs applies to Spain or its debt-ridden neighbor Italy.

"You can't draw a straight line and say once they cross 7% they need a bailout. Spain and Italy can afford higher interest rates. Both these countries are solvent," said Randolph.

What's Next?

Still, the coming months will likely decide Spain's fate.

Goldstone predicted by the end of the year Spain will be forced into a partial default like Greece was, leading to a writedown of some of its debt.

This scenario would trigger massive losses for Spain's banks, which thanks to the LTRO hold much of its debt. Critics say these banks have also been extremely slow to mark their real-estate assets to market, leaving them ill-equipped to cope with steep expected drops in property values.

"In my opinion, all of the Spanish banks are zombie," said Harvey. "A serious mark to market would put all banks into the insolvent range."

Ultimately, Goldstone believes, Germany and the ECB will need launch a rescue of Spain's banks to keep them afloat.

In this scenario, other eurozone banks are also likely to be slammed. Data from the Bank for International Settlements shows that French and German banks hold a combined 822.5 billion euros of exposure to Italy and Spain.